BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
ETHEL BARKSDALE WACK)

Appearances:

For Appellant: J. B. Scholefield, Certified Public Accountant

For Respondent: W. M. Walsh, Assistant Franchise Tax Commissioner; James J. Arditto, Franchise Tax Counsel

O P I N I O N

This appeal is made pursuant, to Section 18593 of the Revenue and Taxation Code (formerly Section 19 of the Fersonal Income Tax Act) from the action of the Franchise Tax Commissioner on the protest of Ethel Barksdale Wack to a proposed assessment of additional personal income tax in the amount of $1,667.48 for the year 1938.

In 1932 Appellant's mother, Mrs. Barksdale, caused to be organized a corporation known as the Brandycliff Development Corporation to which she transferred iO,OOO shares of the common stock: of E. I. Du Pont de Nemours Co. and certain real estate located in New *York* in exchange for the entire 6,100 shares of its stock. In the same year Mrs. Barksdale made gifts of 3,050 shares of Brandy-cliff stock to each of her two daughters, one of whom is the Appellant. The corporation was dissolved on December 29, 1938, and its assets then distributed to its stockholders. The Du Pont stock was purchased by Mrs. Barksdale in 1918 and 1920. A portion of the real estate and certain improvements were acquired prior to December 28, 1928, and a real property, known as Brandywine, was acquired on June 25, 1929.

The Appellant and the Commissioner are agreed that the former realized a capital gain of $524,862'. 31 from her shares in the Brandycliff Development Corporation upon the liquidation of that company in 1938. The only dispute between them relates to the application of the limitation provisions of Section 7(e) of the Personal Income Tax Act (now Section 17712 et seq of the Revenue and Taxation Code) to that amount of capital gain. So far as pertinent herein, the percentage of capital gain to be taken into account, under that Section, in computing net income is 40% in the case of assets held for more than five years but not for more than ten years and 30% in the case of assets held for more than ten years,

Under Section 7(e) of the Act the holding period for the purpose of applying these limitations includes the period during which the assets exchanged for the Brandycliff stock were held by Mrs. Barksdale and the period during which the stock was held by her and by the Appellant, the exchange having been tax free and the stock having been acquired by Appellant as a gift from her mother. It is this requirement that gives rise to the issue presented here by making it necessary to ascertain to what proportion of Brandycliff stock the 40% limitation and to what proportion the 30% limitation should apply. Appellant contends that the apportionment should be made on the basis of the fair market value of the respective assets received by Brandycliff (Du Pont stock and a portion of the realty and improvements having a combined holding period of more than 10 years on the one hand, and Brandywine having a combined holding period of loss than 10 years on the other hand) at the time of their transfer to it, in exchange for the stock. The values as set forth in a schedule submitted by the Appellant have been accepted by the Commissioner, who has stipulated that the recognized capital gain taxable to Appellant, if hsr position be upheld, is $170,752.47. His proposed assessment reflects an apportionment based on the fair market value of the Du Pont stock at the time of its transfer to the corporation and the cost of the real property, adjusted. to the date of its acquisition by the corporation. Apparently realizing that this action was unsupportable, he subsequently argued, though without citing any authority whatever, that the apportionment should be made upon the basis of the costs of the assets adjusted to the date of their acquisition by the corporation.

We are of the opinion that Appellant's position should be upheld. The underlying purpose of that portion of Section 7(d) of the Personal Income Tax Act now found in Section 17747 of the Revenue and Taxation Code is to insure that gain or loss resulting from the ultimate disposition of property received upon a tax-free exchange shall be the same as though no exchange ever took place. See Gann v. Commissioner, 61 Fed. 2d 201, cert. den. 287 U. S. 650 The object of that portion of Section 7(e) now found in Section 17713 of the Code is to provide that the gain or loss so established shall be taken into account only to the extent that it would have been had the original asset been held up to tile time of the disposition of that for which it was exchanged. That object can be achieved only by ascertaining the property for which the original property was exchanged, and tracing tha property received in the exchange through to ultimate disposition. Hence, in this particular case we must decide how much of the total stock of Brandycliff was given up for each asset transferred to it. We think that the market value of each of those assets is the only appropriate key to that problem.

Brandycliff stock was issued in consideration for the transfer to, the corporation of the assets in question and its value was represented by the value of the respective assets at that time, If the Du Pont stock and the real property had been transferred to Brandycliff by several individuals, it is obvious that they would have been entitled to shares of stock only in proportior to value of the property contributed by them to the corporation.

The allocation of stock in this case to the assets involved in proportion to the income tax basis of each of those properties, would be as unreasonable as to declare that had two individuals formed the corporation its stock should have been issued to them in proportion to the income tax basis of the properties contributed no matter how radically that might differ from their actual market value. This however, is the logical conscquenca of the Commissioner's position.

Our view is consistent with the method of apportionment of basis adopted when several securities are received in a tax-free reorganization in exchange for a single issus (I.T. 2335, VI-1CB 18) or where it becomes necessary to apportion a purchase price of a group of assets or securities to individual items in order to determine proper basis for depreciation or gain or loss upon a subsequent sale. Fair market value at the time of exchange is the measure applied in these cases. Clifford Hemphill, 25 B.T.A. 1351; Frances E. Clark, 28 B.T.A. 1225, aff'd. 77 Fed. 2d 89; Walter B. Lasher, 34 B.T.A. 768; and M. F. Lloyd-Smith v. Commissioner, 116 Fed. 2d 642, cert. den. 313 U.S. 588.

It is our view, accordingly, that the stipulated amount of $170,752.47 is the amount of Appellant's capital gain from the transaction in question to be taken into account in computing hor net income for 1938. Certain other adjustments made by the Commissioner in his computation of Appellant's net income for that yeas have not been questioned by Appellant and his action in respect to those adjustments must, accordingly, be sustainsd.

O R D E R

Pursuant to the views expressed in the opinion of the Bonrd on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to Section 18595 of the Revenue und Taxation Code, that the action of Chas. J. McColgan, Franchise Trx Commissioner, on the protest of Ethel Barksdale Wack to a proposed assessment of additional personal income tax in the amount of $1,667.48 for the year 1938 be and the same is hereby modified; the Commissioner is hereby directed to take into account in computing the net income for 1938 of said Ethel Barksdale Wack the amount of $170,752.47 as capital gain from the liquidation of the Brandycliff Development Corporation; in all other respects the action of the Commissioner is hereby sustained,

Done Ct Sacramento, California, this 5th day of January, 1949, by the State Board of Equalization.

Wm. G. Bonelli, Chairman
J.H. Quinn, Member
J. L. Seawell, Member
G. R. Reilly, Member

ATTEST: Dixwell L. Pierce, Secretary